Quarterly valuation update for the energy and infrastructure sector

Q1 2023 update and spotlight on ESG

mazars

Quarterly valuation update
Introduction

Welcome to the Q1 2023 edition of our quarterly valuation update, which provides a snapshot of some of the main publicly available valuation trends across the energy and infrastructure sector, covering both debt and equity metrics.

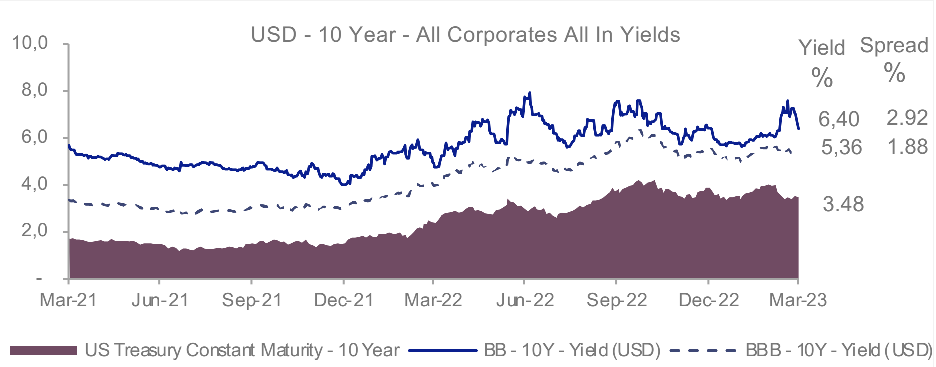
This quarter we continue to look at trends in debt and equity metrics relying primarily on publicly available information. In relation to the equity trends, we use the Mazars indices of listed infrastructure funds and listed renewable energy funds, compiled on the basis set out in Appendix 1 to this update.

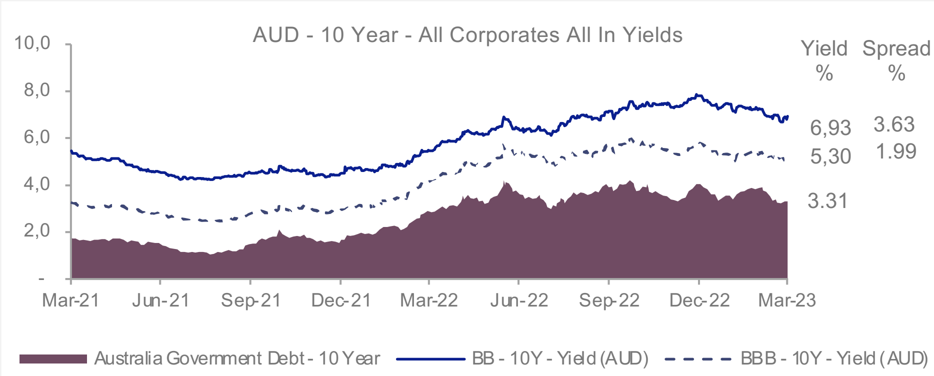
In addition, this quarter we have included a spotlight on ESG and how far ESG considerations should influence the approach to infra and energy valuations.

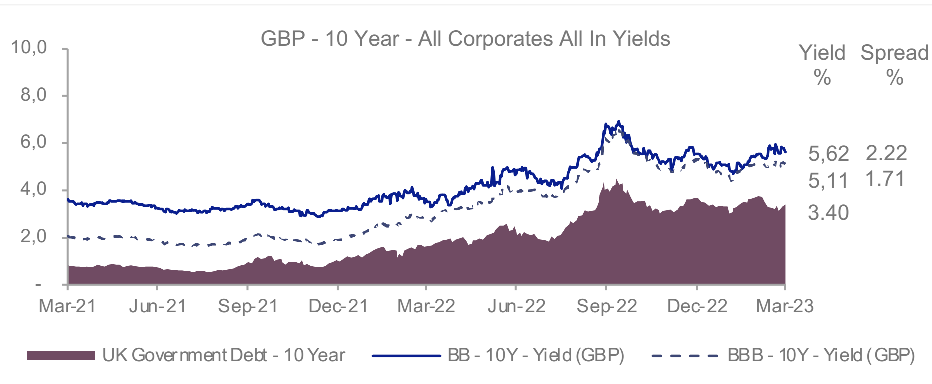
Quarterly valuation update
Debt valuation trends

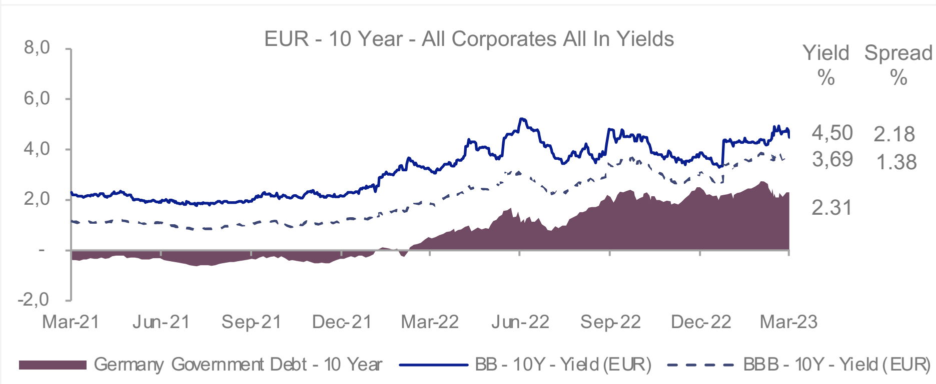
The cost of debt has been relatively stable recently – but at levels that are significantly higher than they were a year ago

- Government bond yields are relevant to valuations because they are often used to inform the risk-free rate and also influence the cost of debt.
- The below graphs show that the past 6 months has seen relatively stable long-term yields in various major markets, with increases to base rates already factored in. This amounts to a significant and sustained change to the cost of debt from a year ago across markets. Asset owners have had to adjust to this new reality.
- Credit spreads for corporate bonds (10Y) have also widened slightly overall during the quarter. We are seeing some mixed evidence in the private debt space, with specific sub-sector trends.





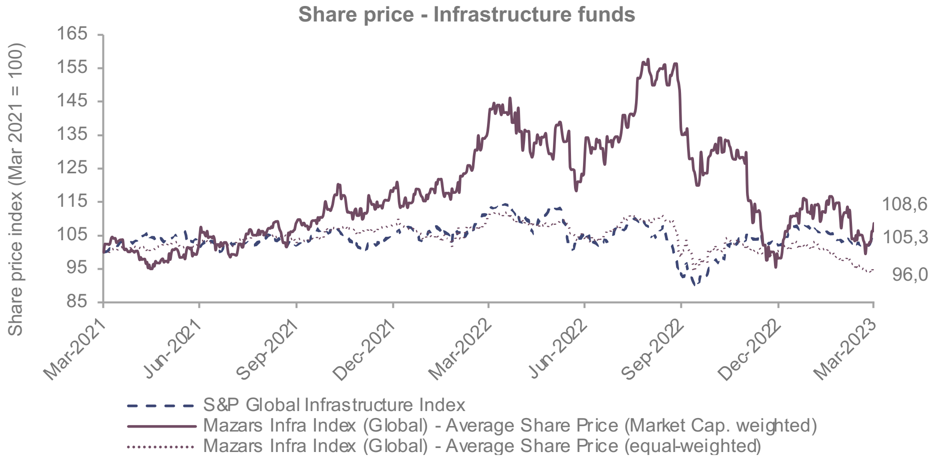




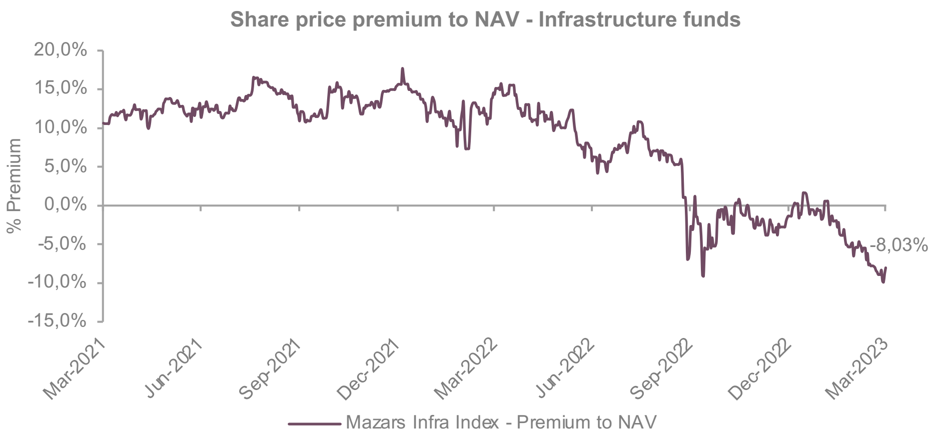
Source: Capital IQ, Mazars analysis

Quarterly valuation update
Equity valuation trends – infrastructure funds

Discount rates have started to rise – but the signal from the market is that they may have further to go



Source: Capital IQ, Mazars analysis



Source: Capital IQ, Reports from Funds, Mazars analysis

- The top left graph shows that the recent share price trend for infrastructure funds has been mostly flat. But what this means in practice is the crystallisation of the market movements in September 2022, with most funds trading at a discount to NAV and some trading at a significant discount to NAV.
- This may partly reflect broader sentiment in the investment management space rather than being purely infrastructure-specific. However, the prolonged period of discount is also likely to reflect an expectation that recent discount rate increases may have further to go.
- It can also create its own dynamic: when trading at a significant discount to NAV, funds may have policies that restrict the level of investment, reducing overall market liquidity and thus allowing buyers of assets to achieve higher returns than they would do otherwise.

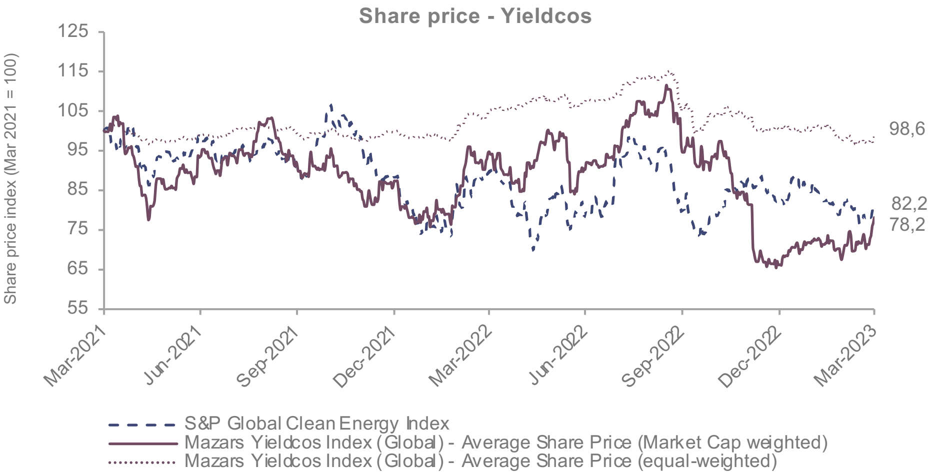
“Transaction levels remain muted and there is insufficient evidence to justify a movement in the portfolio reference discount rates.”– HICL (Interim Update Statement, March 2023)

“During the second half of 2022, the number of availability-style transactions slowed materially in part due to the changing macroeconomic environment.”– BBGI (Annual Results Report, 2022)

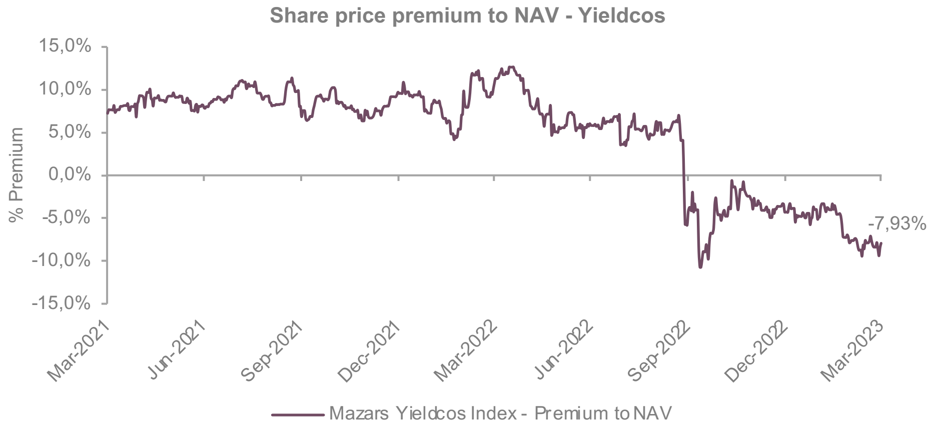
**especially for the NAV reporting funds*

Quarterly valuation update
Equity valuation trends – renewable energy funds

Market appetite for assets remains strong and the funds continue to trade at a discount to the NAVs



Source: Capital IQ, Mazars analysis



**The NAVs for New Energy Solar Ltd (ASX: NEW) include share capital return from 28 Nov 2022 onwards*
Source: Capital IQ, Reports from Funds, Mazars analysis

- Similar to infrastructure funds, the share prices of yieldcos generally declined this quarter (on an equal weighting basis), and the average discount to NAV is now similar to levels last seen at the end of Q3 2022.
- All the dynamics relevant to the market perception of infrastructure funds apply to the yieldcos too. In addition, there are headwinds from lower power prices (following a period of much higher prices) and potentially higher regulatory risk with significant market reforms being proposed in several markets. These headwinds may be offset by other elements, such as the value now being placed on REGOs and the increased availability of corporate PPAs to hedge power price risk in the short and medium term.
- The fact that most yieldcos are currently trading at a discount to NAV suggests that the market believes there may be further reductions to asset valuations to come.

"Competition for renewable assets has remained high, dampening the extent to which benchmark rate rises have fed through into asset discount rates."– ORIT (Annual results report 2022)

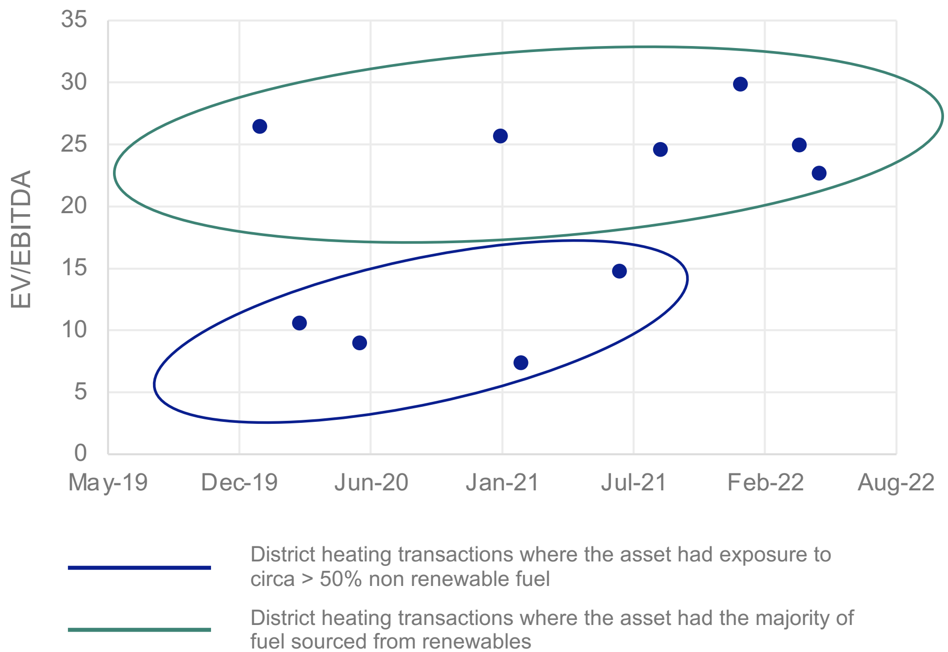
"During the year we have observed continuing strong competition for renewables infrastructure, which remains a sought-after asset class. Whilst transaction evidence is not yet demonstrating a clear increase in discount rates, the yield of long-term government bonds has increased since 30 June 2022."– TRIG (Annual results report 2022)

Quarterly valuation update
Spotlight on: how ESG factors impact on valuations

In the past few years, Environmental, Social and Governance ("ESG") reporting has become increasingly common across the infrastructure sector. But have ESG factors impacted directly on asset valuations and how should they be incorporated into a valuation exercise?

- The below chart looks at 10 European district heating transactions from the past two years, with a focus on the impact of the "E".
- It suggests that there is a clear difference in how investors have valued district heating companies with lower carbon emissions vs those with higher carbon emissions.
- Why is this? We explore two main reasons on the right hand side

Recent European district heating transactions



1) **ESG as shorthand for risks that have always been important valuation drivers**
   - In the context of valuing infrastructure assets, many ESG themes were important considerations long before the label existed
   - In the case of district heating, ESG considerations could be understood in terms of material financial and operational risks arising from requirements to decarbonise (akin to the risks of multiple development projects) and exposure in the meantime to carbon price risk.
   - All these would be factored into any valuation through an adjustment either to cashflow forecasts or to the discount rate applied, thus driving a lower multiple

   But there may be something else going on as well.

2) **ESG as liquidity driver**
   - Investors increasingly have mandates which require explicit consideration and policies relating to ESG factors
   - This is leading to investment decision-making which is based not just on considerations around risks and returns but also on whether ESG requirements are met.
   - In the case of district heating, this has had a direct impact on liquidity: very simply, there are more investors interested in decarbonised district heating companies than coal-fired district heating companies. A shrinking pool of investors will inevitably reduce transactional competition and thus pricing over time.
   - This amounts to a grey levy (over and above the specific risks highlighted above) applied to valuations.

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An approach to integrating ESG considerations into valuations

Most infra and energy subsectors are less clear-cut than the district heating example and a nuanced approach to incorporating ESG considerations into valuations is therefore needed

- As noted on the previous slide, for investors, ESG will often be incorporated directly into investment mandates
  - This means, when appraising a specific opportunity, ESG considerations may well be binary initially – whether or not the asset meets its investment criteria
  - Put another way, ESG considerations will often impact on investment appetite (positively or negatively) first and pricing second.
- From a valuation perspective, there is no specific investment mandate to consider, but there may similarly be a multi-stage assessment:

Selected questions for a valuer	Considerations
Is the sub-sector one where ESG considerations are typically prominent?	• Some sectors may be more attractive than others because of ESG drivers. Within sectors, ESG considerations may not always be central • On the other hand, big questions around carbon emissions, concerns around supply chains and contractors, or around the transparency of management reporting are all examples of issues that would always need to be considered in a valuation. They are all likely to translate into higher political and regulatory risk or other risks to the cashflow forecasts being considered
Are there any big ESG concerns associated with the asset?	• It is typical to start with risks rather than potential upsides, as whilst a positive ESG story can also impact on valuations, ESG is more often a hygiene factor that determines whether an asset should be valued in line with peer benchmarks • If there are specific ESG issues identified, these would normally feed into cashflow adjustments or adjustments to the discount rate applied
If the asset has a positive ESG story, does this make it stand out?	• A positive ESG premium may be possible, although may also be understood in more mainstream ways. • For instance, a positive approach to maintaining an infrastructure asset may be seen as having a positive score in relation to the "S" of ESG, benefiting users of that asset. But from a valuation perspective, it would be typical to focus on the positive impact on asset condition and, in light of that, adequacy of maintenance and lifecycle assumptions and asset life assumptions.

Quarterly valuation update
Conclusions

Three key themes from Q1 2023:

Cost of debt has settled in a new range, and asset owners are having to adapt to this	Long-dated gilt yields indicated a relatively stable trend over the past quarter, which therefore crystallises the rising yields experienced in H2 2022. Private debt transactions are still taking place, but asset owners are having to accept the higher cost.
High levels of competition for energy and infrastructure assets; transactional discount rates have remained high	Strong competition for energy and infrastructure assets has limited the extent of increases on asset discount rates to date. But the capital markets are expecting more to come.
ESG considerations are increasingly impacting on asset valuations, although the reasons for this are complex	ESG impacts on investment appetite, and therefore liquidity and pricing. It also impacts on specific risks that would in any case need to be considered in a valuation exercise. It may not need to be separated out explicitly, but ESG can't be ignored by a valuer.

Appendix 1
Information about the Mazars indices

Infrastructure is an increasingly mature asset class, with an increasing number of listed and unlisted funds set up specifically to invest in and manage real assets across the infrastructure and energy sectors. For the purpose of our analysis, we have constructed two global indices that focus on listed funds, as follows:

- An index of infrastructure funds, currently including 8 funds with activities across 15 countries
- An index of renewable energy funds, currently including 20 funds with activities across 23 countries

While other infrastructure and energy company indices exist in the public domain, they tend to have a broader scope, including for instance construction companies, transport operators, concessionaires and utilities to gauge broad sentiment across the sector.

By focusing on pure asset owners, the Mazars indices aim to be more closely aligned with market sentiment on the valuation of these assets. This is reflected in this update and includes a number public statements from funds on how they are currently approaching their own valuations.

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